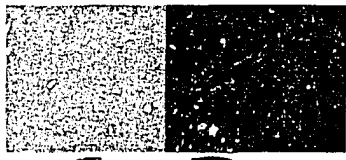


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# AGENCY FOR INTERNATIONAL DEVELOPMENT

A.I.D. Evaluation Special Study No. 71

Center for Development Information and Evaluation

September 1993

## **A.I.D. Assistance to Panama** *Evaluation of the Post-1989 Program*

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**U.S. AGENCY FOR INTERNATIONAL DEVELOPMENT**

**September 1993**

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*A.I.D. Evaluation Special Study No. 71*

# **A.I.D. Assistance to Panama**

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## ***Evaluation of the Post-1989 Program***

by

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**Center for Development Information and Evaluation  
U.S. Agency for International Development**

**September 1993**

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# Preface

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**T**his evaluation was conducted for the Agency for International Development, Center for Development Information and Evaluation (CDIE) under Contract No. 525-9999-C-00-2278-00 from September through December 1992 by Dr. Jacques Polak, Dr. Anne Krueger, and Dr. John Newton. After carrying out initial interviews and a background review in Washington, D.C. in September 1992, the team traveled to Panama in early October and interviewed the principal actors and beneficiaries of the USAID/Panama program, including private sector investors and

bankers, Government of Panama officials, and Mission and U.S. embassy officers.

The evaluation team thanks Dr. John Eriksson, CDIE Director, and his staff for their support during this evaluation. Dr. Juan J. Buttari, the CDIE project officer, was particularly helpful. Thanks are also due to the many Government of Panama, private sector, and USAID Mission officials who took time during the project to be interviewed by the team. These officials, too numerous to mention here, are listed in Appendix A.

# Summary

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## Introduction

**D**uring the 2 years preceding the 1989 U.S. military action in Panama (code named Operation Just Cause), the Panamanian economy had seriously deteriorated, largely because of economic mismanagement by the military government, public corruption, and U.S. and international sanctions and payment embargoes. With suspension of U.S. tax payments and canal fees to the Government of Panama and freezing of National Bank of Panama reserves and check clearing by the U.S. Federal Reserve, Panama's international banking center activities collapsed. As a result, offshore deposits fell from \$22 billion to \$4.5 billion and Panamanians began withdrawing their bank deposits. The crisis resulted in the declaration of a 9-week bank holiday, further aggravating the financial crisis. Making matters worse, the public policy and structural adjustment reforms supported by U.S. and multilateral aid and lending programs were suspended during 1988-1989, with negative impacts on growth, productivity, and public revenues.

In response to this economic crisis, and following the surrender of General Manuel Noreiga in December 1989, the United States initiated a \$ 1 billion assistance package for Panama, of which nearly one-half was to be administered by the U.S. Agency

for International Development (A.I.D.) through Economic Support Funds for Panama's economic recovery and emergency needs. Announced by President Bush on January 25, 1990, the A.I.D. program had three objectives: (1) to alleviate the suffering of low-income groups adversely affected by Operation Just Cause, (2) to support economic recovery in general and to lay the groundwork for sustained growth, and (3) to support the democratic process. The bulk of the A.I.D. assistance focused on Panama's economic recovery.

In February 1990, the United States provided \$41 million in emergency assistance for housing and employment to assist low-income groups directly affected by the U.S. military operation. In May 1990, the U.S. Congress passed the Dire Emergency Assistance Act, which made available an additional \$420 million in grant funds for Panama's economic recovery and long-term human and institutional needs. The economic recovery component of the program comprised three parts: a private sector reactivation program, a public sector investment program, and a program to assist Panama in settling its arrears with international financial institutions. This three-part program is the focus of this evaluation.

## Summary of Results

When Panama's most immediate needs had been met by the \$41 million emergency assistance package in the early months of 1990, the \$420 million economic assistance program was gradually phased in, starting in the fall of 1990. The bulk of the program, \$351.8 million, was directed at Panama's economic recovery, with the following results.

### Private Sector Reactivation

*Safety net for banks.* The capital flight that had taken place in 1987 and 1988 posed serious liquidity problems for the Panamanian banking system that were countered in part by the freezing of bank deposits. To facilitate the greatly needed removal of the freeze, A.I.D. designed a "safety net" for the banks and set aside \$108 million for this purpose. However, even before the A.I.D. safety net was in place, the reflow of Panamanian money into the banks had begun, from returning capital from abroad and from mattresses, which did much to relieve the banks' liquidity position in the first half of 1990. In addition, the banks, concerned about the impending unfreezing of deposits, hastened the reflows by offering high interest rates for deposits at well above London Interbank Offer Rates (LIBOR). The improved liquidity of the banks thus made future claims on a safety net unlikely, although it did not provide a sufficient case for dropping the concept.

The widespread discussion of a safety net, as distinct from its actual creation in July 1990, was credited by many parties in the financial sector as an important factor in the smooth liberalization of deposits. Simi-

larly, President Bush's January 1990 announcement of the \$1 billion support package, the release of about \$41 million in February in emergency assistance, followed by Congressional authorization in May of the \$420 million for economic recovery served to convince the people of Panama that the financial might of the United States was backing Panama's economic and financial system. This belief probably did more to prop the system than the specifics of the safety net.

*Reactivation of the economy.* As the probability of the need for a safety net receded, a new idea for the use of the money originally set aside for this purpose developed, namely to reactivate, or "jump start," the economy by funneling A.I.D. resources through the banking system to the private sector. Under the program called Fondo de Recuperación Económica Nacional (FREN), A.I.D. made \$108 million available to the National Bank of Panama, which used the money to buy certificates of deposit (CDs) from participating banks for the equivalent of 50 percent of loans that met the terms of the facility. The main requirement of such loans was that they be medium term, between 1 and 5 years.

The banks chose to whom to lend and on what terms. They carried the full risk of the loans they made under this program. It followed from this approach that A.I.D. money could not be tracked to particular expenses in Panama or abroad except in the most general terms, such as the industrial breakdown of loans. The evaluation team believes the decision to leave such decisions to the banks was correct. Moreover, if A.I.D. had pressured the banks to actively pursue other aims in using Agency money, such as the promotion of small businesses

or credit to agriculture, the primary aim of giving a strong push to Panama's economic recovery would have suffered.

From mid-1990 to March 1992, total loans of all private banks in Panama increased by nearly \$1 billion, compared with \$284 million increase in medium-term loans of participating banks during the same period. Clearly, the banking system was in an expansionary phase that preceded the start of FREN in late 1990 (loans had increased by \$210 million in the second half of 1990) and continued after the end of FREN. The expansion was particularly strong in the Panamanian-owned banks, which accounted for more than 75 percent of the increases of loans and of private sector deposits in the banking system between June 1990 and March 1992.

Although the FREN program was open to all private banks, Panamanian banks accounted for more than 93 percent of its use, even though they had only about 40 percent of the loans and half of the private sector deposits of all private banks (end of 1990 data). This was because the foreign banks had ready access to international capital markets, at interest rates close to LIBOR (below the rates charged on the CDs under the program), whereas the Panamanian banks generally had to pay substantially higher rates to attract private deposits. Given the difficulty of Panamanian banks in accessing the world money markets, it is reasonable to assume that the \$108 million provided under FREN added that much to investment in Panama, or some 14 percent of total investment in 1991.

Taking into account the income effects of subsequent rounds of spending, a rough estimate of the total impact of the program

on Panama's gross domestic product (GDP) is about \$125 million, or 2.5 percent of total 1991 GDP (\$5.075 billion). The effect of FREN on employment appears to be about 13,000 person-years. While FREN and other stimuli (including a \$90 million swing in direct investment and a \$20 million increase in exports) had a positive effect on employment, the overall unemployment rate declined only slowly from the high level reached during the crisis years (16.3 percent in 1988 and 1989 compared with 11.8 percent in 1987). Unemployment for 1991 still stood at 15.7 percent and is estimated at 15 percent for 1992.

On the occasion of the program's mid-course review there was certainly no reason to discontinue the program when it became evident during 1991 that the economy was on a solidly expansionary course. Moreover, switching to another expenditure program would have involved delays that risked interrupting the tempo of the ongoing recovery.

*Use of the reflows from FREN CDs.* Was the portion of the A.I.D. program devoted to FREN well spent? Perhaps the most accurate answer would be that it was *not* spent. Rather, that component of the aid grant was invested in bank CDs for later use. For accounting purposes, the purchase of CDs may be registered as disbursement, but unlike the purchase of brick, mortar, and machines, the purchase of CDs does not represent a final disposition of the money. There is every reason to expect that the money will continue to return, with interest, and that only then will the Government of Panama finally disburse that portion of U.S. aid.



The reflow of aid money, once used, is not a new experience, but the form it takes in Panama is unusual. In countries with their own currencies, the reflow takes the form of local currency balances, or counterpart funds. These arise, for example, as goods financed from aid dollars are sold in the country. In most cases, A.I.D. has had little interest in supervising the use of these balances, since the receiving government could readily circumvent any restrictions applicable to their use by printing additional amounts of its own currency. But because Panama uses the U.S. dollar as its currency, the aid reflows are the equivalent of a new \$100 million aid program over the next 4 years. There is a provisional understanding between A.I.D. and the Government of Panama that this reflow money will be used to repay nonmilitary debt to the United States. But because these debt payments will in any event have to be made, the reflows will in fact become available as general budgetary support.

The conditionality attached to the public investment program will end after the release of that program's third tranche. Given this fact, A.I.D. would have had good reason to prolong the policy impact of its assistance by making the use of CD reflows conditional on Panama's continuing adherence to the international lenders' structural reform requirements.

The evaluation team believes that the Agency did not need to attach a separate set of conditions to the FREN program. U.S. interests in economic reform in Panama were sufficiently safeguarded by the conditions attached to the use of the portion of aid devoted to public investment (see the section that follows and Section 3 of the report). It would therefore have been counter-

productive to delay the availability of FREN until the conditions applicable to the release of the remainder of the \$420 million aid package had been fulfilled.

*Applicability of the FREN program to other countries.* The Panama aid program is unique. It is therefore highly unlikely that the need for a similar program in another country will present itself. But if A.I.D. does become involved in another situation in which a developing country needs a stimulatory policy and the Agency has the resources to backstop the policy, A.I.D. should insist on a well-conceived credit-expansion scheme as a condition for its assistance. In the case of Panama, the long deliberations with the Government of Panama had produced such a plan. In general, however, governments that have tried to channel additional credit to the private economy, whether through the central bank or otherwise, have experienced uneven results. (An extensive analysis leading to a mostly negative conclusion of the widespread practice of "directed credit" is provided in Chapters 4 and 5 of the *1989 World Development Report* [World Bank 1990].) It is important to note that any program that attempts to stimulate bank lending by adding to the banks' liquidity risks distorting the flow of capital if it tries to use excessive regulation to control the purposes or the terms of the banks' lending. Fortunately, the Panama program avoided most of the risks of directed credit.

## Public Sector Investment

One of the worst casualties of the squeeze on government finance in the 1987-1988 crisis years in Panama was public investment, and it took a long time to re-

verse the trend. Even under the new Government, the budget resources available for public investment remained constrained; moreover, it took a major effort to bring official spending under proper control. Consequently, few projects became ready for financing in 1990, and the slowdown in the project portfolio stretched well into 1991.

*Need for a public sector investment program.* The resulting backlog in public sector investment made a public sector investment program (PSIP) a natural element in A.I.D.'s recovery program for Panama. PSIP funds were used for priority investments in agriculture; health, education, justice, and other social sectors; natural resources; and infrastructure. Of the \$113.9 million available for PSIP, \$20 million was channeled through the Social Emergency Fund to support a large number of small, labor-intensive, local social development programs. But for Panama's economy to experience healthy growth, many of the structural impediments had to be removed as well, such as the following:

- Excessive employment in the public sector
- Inefficient operation of public sector enterprises
- Inadequate public investment and maintenance
- A tax system that discourages investment and the use of labor
- Very high trade protection aimed at import substitution and self-sufficiency in food
- Extensive price controls in support of protective trade and agricultural policies
- An overregulated labor market

- An underfunded and overly generous social security system
- Technical insolvency of four public banks and a weak regulatory and supervisory framework of the commercial banks

Structural change was, accordingly, the central focus of the World Bank and the Inter-American Development Bank (IDB) in their relations with Panama. A.I.D. pursued the same objective by attaching its conditionality for the PSIP to that of these two international lenders.

*Conditionality for the PSIP.* Specifically, A.I.D. made the release of the second and third tranches of the PSIP conditional on Panama's progress in its negotiations with the World Bank and the IDB. The release of the first tranche in October 1990 was made conditional not on action taken by Panama in the structural adjustment field, but on submission of specific plans for action in the subsequent period, covering public finance, privatization, trade liberalization, and improvement of Panama's international competitiveness. Given Panama's limited personnel resources, this initial focus on broad, careful planning, rather than on quick action on a few measures, was appropriate.

By linking the release of the next two PSIP tranches to World Bank and IDB appraisal of Panama's structural adjustment, A.I.D. could not have the same assurance as the two lending institutions that its money would buy the hoped for adjustment. Nevertheless, the evaluation team believes that A.I.D. applied a proper degree of conditionality. Had A.I.D. designed its own conditionality, it would have confused the Panamanian Government concerning the

Agency's policy reform priorities. At the same time, A.I.D. acted wisely in designing its disbursements in a somewhat different time frame from that of the World Bank and the IDB by giving somewhat greater weight to political considerations. Also, because A.I.D.'s high-profile association with Panama was intended to be short lived, the Agency could not stretch its disbursements over as long a period as could the international financial institutions.

A.I.D.'s association with structural adjustment in Panama was not limited to the conditionality of its grants. With a larger continuous presence in Panama than any of the international financial institutions, A.I.D. acted as a conditionality expeditor for the new Government in Panama, which was critically shorthanded.

### **Settling Arrears With the International Financial Institutions**

In order for Panama to receive new credits from the international financial institutions, it had to settle the arrears it had incurred with those institutions during the crisis years. But necessary negotiations took much longer than expected, and agreement was not reached until February 1992. The resources required to achieve settlement—which in the end amounted to \$658 million—consisted of \$130 million from the U.S. aid program, a \$3 million grant from France, a cash payment by Panama of \$248 million, loans from Japan and Taiwan, and initial disbursements of new loans from the international financial institutions.

Because the \$130 million from the U.S. program was not disbursed until the required arrangements had been agreed to with the international financial institutions, A.I.D. conditionality was automatically linked to Panama satisfying the conditions of those institutions. That linkage was, in the view of the evaluation team, entirely appropriate.

### **Lessons Learned and Recommendations**

A.I.D.'s Panama assistance program was in many respects unusual. The program had to be organized in an extremely short time, immediately after a military operation, leaving little time for observing the country's needs and planning how to meet them. Panama's per capita income of about \$2,000 was outside the usual range for intensive A.I.D. assistance. Moreover, the absence of a Panamanian central bank and a currency of its own—the complete reliance of the Panamanian economy on the U.S. dollar—gave the country a financial structure radically different from that of most recipient countries: full convertibility, a high-quality banking system, and, perhaps, most important, the inability of the government to finance a budget deficit by inflationary means.

Nevertheless, a number of lessons and recommendations can be drawn from the A.I.D. experience that program designers can apply to a wider scope of countries. These are summarized in the box.

## Lessons Learned and Recommendations

- If lack of demand is the problem in an aid-recipient country, A.I.D. can use part of its resources to overcome this deficiency, either by sponsoring a fast-disbursing domestic program or by pumping additional resources into the banks, thus inducing them to step up lending. It cannot be expected that a domestic spending program will also improve the liquidity or the tempo of bank lending.
- If A.I.D. chooses the second alternative (e.g., because of severe unemployment), it should not assume any risks from the bank loans. The CD approach used in Panama met that test. The corollary of this approach is that the recipient-country government should leave the choice of debtors, terms, and projects overwhelmingly to the banks and resist the temptation to use the A.I.D. program to pursue a variety of other objectives.
- A.I.D. may supply a grant to the recipient country, but funds supplied to the banks in support of their lending activity should return to the government as the loans are due for repayment (even if the borrower fails to repay). A.I.D. should consider this reflow as a new aid program to which it can suitably attach some degree of conditionality—the more so if the original "disbursement" to the banks was made without conditionality in order to expedite the process.
- In countries where the programs of the international financial institutions carry a broad spectrum of conditionality that coincides substantially (if not in every detail) with A.I.D.'s objectives in structural adjustment and the resources of the financial institutions are a multiple of that of A.I.D., the Agency should not specify its own conditionality. Rather, it should piggyback onto suitably selected release conditions of one of the financial institutions.
- In such a setting, A.I.D.'s support of the conditionality of the international financial institutions is primarily moral rather than financial; it is therefore appropriate for A.I.D. to exempt from this conditionality certain subprograms or portions of programs that it considers too urgent to delay, as in the case of the private sector reactivation program in Panama, which was already late when it went into effect in the fall of 1990. A.I.D. might also have taken similar action for some portion (e.g., one-half) of each of the three tranches of the public sector investment program, provided the Agency had specified in advance the circumstances under which such action could be taken.
- Finally, the experience in Panama shows the drawbacks of a rigid program that is tightly allocated long before the magnitude of the country's needs or the contributions from other sources can be defined. Such drawbacks in Panama did not originate with A.I.D.; rather, they were associated, first, with the political process of high-level interagency decision-making about a program that the U.S. Government could support and, second, with the process of piloting this program through Congress. Consequently, any remedial action in a similar program should be taken at these earlier stages, before A.I.D. is given a program to administer. Nevertheless, in such a situation it is up to A.I.D. to wield all its influence at the design stage to ward against any undue rigidity in the emerging program.

# Glossary

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<b>A.I.D.</b>	U.S. Agency for International Development	<b>GAO</b>	U.S. General Accounting Office
<b>CD</b>	certificate of deposit	<b>GDP</b>	gross domestic product
<b>CNB</b>	Comisión Nacional Bancaria	<b>IDB</b>	Inter-American Development Bank
<b>CDIE</b>	Center for Development Information and Evaluation	<b>IMF</b>	International Monetary Fund
<b>DESAA</b>	Disaster Emergency Supplemental Assistance Act	<b>LIBOR</b>	London Interbank Offer Rate
<b>ESF</b>	Economic Support Funds	<b>PSIP</b>	public sector investment program
<b>FREN</b>	Fondo de Recuperación Económica Nacional (private sector reactivation program)	<b>USAID/ Panama</b>	A.I.D. Mission in Panama

## Introduction

This report presents the first independent, formal evaluation of the U.S. support program for the economy of Panama, administered by the U.S. Agency for International Development (A.I.D.) after Operation Just Cause in December 1989. Designed to promote the economic recovery of Panama and to address certain serious social needs, the support program has been the subject of audits by A.I.D.'s Inspector General, a draft report by the General Accounting Office (GAO), and informal press reviews. This evaluation complements those reviews with an economic analysis of the impacts of the program and of its initial objectives and goals, as well as a discussion of the applicability of the program approach to future, perhaps similar, situations.

The A.I.D. Panama program was initiated against a backdrop of severe economic decline, fiscal and monetary crisis, and political turmoil. Announced by President Bush on January 25, 1990 as part of a \$1 billion assistance package, the program had three objectives: (1) to alleviate the condition of low-income groups affected directly by Operation Just Cause, (2) to support economic recovery in general and lay the

groundwork for sustained growth, and (3) to support the democratic process. The economic recovery part of the program comprised three parts: a private sector reactivation program, a public sector investment program, and a program to assist Panama in settling its arrears with international financial institutions. This three-part economic recovery program is the focus of this evaluation.

## Program Background

The economy of Panama had deteriorated seriously in the 2 years preceding the 1989 U.S. military action, code named Operation Just Cause. Economic mismanagement by the Panamanian military government, public corruption, and U.S. and international sanctions and payment embargoes were some of the factors responsible for the deterioration. Although the economy was characterized then as now by a relatively high per capita income for the region and by the use of the U.S. dollar as both the local currency and the currency (and basis) of the country's international financial center, these advantages were largely nullified by sanctions-related events that began in early 1989.

-1-

With suspension of U.S. tax payments and canal fees to the Government of Panama and freezing of National Bank of Panama reserves and check clearing by the U.S. Federal Reserve, Panama's international banking center activities collapsed. By the end of 1988, offshore deposits had fallen from \$22 billion to \$4.5 billion, and Panamanian residents had begun to withdraw deposits, leading to declaration of a 9-week bank holiday. The results were universally negative for the economy of Panama during 1988, with gross domestic product (GDP) dropping by 16 percent; domestic deposits and credit dropping by 11 and 17 percent, respectively; and imports and exports dropping by 35.3 and 13.5 percent, respectively.

Although Panamanian economic activity did not decline much further in 1989, the recession continued on all fronts, with continued balance of payments and fiscal deficits. Perhaps more important, the process of public policy and structural reform, formerly supported by U.S. and multilateral aid and lending programs, was suspended and reversed during this period, engendering difficulties both immediately and in the long term with reviving growth, productivity, and public revenues. Concomitantly, the stock of analytical reports and background material normally prepared by multilateral donors, USAID Missions, and A.I.D./Washington, and used for development planning, began to seriously lag behind events in Panama.

Against this backdrop, the A.I.D. program, begun after the surrender of General Manuel Noriega in December 1989, faced much more serious and immediate objectives and scheduling than did the usual USAID Mission effort. Approximately one-half of the \$1 billion assistance package announced by President Bush on January 25, 1990 was to be disbursed by A.I.D., largely as Economic Support Funds (ESF).<sup>1</sup> Although the recovery-related objectives of the program were of immediate importance to the Panamanian economy, the need for a U.S. political consensus on funding meant that the enabling legislation—the Dire Emergency Supplemental Assistance Act (DESAA)—was not passed until May 25, 1990. Within the next 16 months (the end of FY 1991), A.I.D. had obligated all of this funding, of which 82 percent was actually disbursed by February 1992. To place this funding in a worldwide context, the Panama aid program is the largest administered by A.I.D. in per capita terms, surpassed only by programs in Israel and Egypt in absolute terms. Moreover, in the case of Israel, administration is often not required at all and no short-term emergency programming is involved. The Panama program, in terms of both planning and implementation, presented unique problems.

The program's objectives, as stated in the Mission Project Papers and Program Assistance Approval Documents (PAAD)

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<sup>1</sup> The remainder of the package (\$577 million) included grant food aid and access to trade and investment guarantee funds and trade preference systems. These elements of aid are not addressed in this evaluation.

were (1) to alleviate the suffering of low-income groups directly and immediately affected by Operation Just Cause, (2) to support economic recovery in general and lay the groundwork for sustained growth, and (3) to support the democratic process. Although the program elements are closely integrated, certain components relate more directly to specific program objectives and to specific conditions of the Panamanian economy. The immediate objective of relieving the needs of affected low-income groups was addressed early on, in February 1990, by the program's emergency assistance component of about \$41 million, directed at low-income housing guarantees and employment programs. The complete DESAA, passed May 25, 1990, provided an additional \$420 million in grant funds, of which \$351.8 million was directed at macroeconomic recovery, reestablishing a stable credit standing with the international financial institutions, and backing renewed private and public sector investment. An additional \$54.2 million of the \$420 million was allocated to the development assistance component for supporting long-term human and institutional needs (see Table 1).

The urgency of Panama's needs and the understandable disarray of the newly established Panamanian Government in early 1990 required innovative planning and implementation by USAID/Panama. In this context, A.I.D.'s decisions to indicate "re-reform" of certain economic policies as the conditionality for public sector ESF transfers, to provide private sector ESF transfers

without policy conditionality, and to channel a major portion of program support through the private banking sector are outstanding elements of such innovation, addressed in later sections of this evaluation.

## Evaluation Objectives

This evaluation was commissioned to address several issues specific to the prevailing conditions in Panama, in addition to the standard objectives of an ESF evaluation. As for most such evaluations, the analysis of the Panama program is directed at the planning, implementation, and monitoring of the program's three components; Government of Panama compliance with conditionality; and the economic impacts resulting from the program. In addition, the evaluation sought a more in-depth analysis of several issues that arose from the Inspector General, GAO, and press reports mentioned earlier, as well as an assessment of the basic design, appropriateness, balance, and timing of the program. (See Appendix A for a more detailed list of target issues.) The specific goals and means of implementation of this program—including short-term alleviation of suffering by low-income groups affected by Operation Just Cause and the innovative use of the private banking sector as the vehicle for distributing a major portion of the funds—indicate the need for a more complete assessment of impacts on the specific subsectors involved.



**Table 1. U.S. Economic Assistance to Panama  
Status of Funds Appropriated**

	Programmed FY 1990 \$ Millions	Agreements Signed As of 01/31/92 \$ Millions	Disbursed to GOP As of 01/31/92 \$ Millions
<b>Emergency Needs Assistance</b>	<b>40.8</b>	<b>40.8</b>	<b>40.0</b>
Food, Shelter, and Replacement Housing for Displaced People	23.3	23.3	22.7
Emergency Employment Program	7.2	7.2	7.1
Small Business Credit Fund	5.0	5.0	5.0
Emergency Public Sector Support	5.3	5.3	5.2
<b>Immediate Econ. Recovery Assistance</b>	<b>351.8</b>	<b>351.8</b>	<b>309.7</b>
Normalization Relations With IFIs	130.0	130.0	130.0
Public Investment	113.9	113.9	71.8
Private Sector Reactivation Credit	107.9	107.9	107.9
<b>Development Assistance</b>	<b>54.2</b>	<b>54.2</b>	<b>14.5</b>
Administration & Policy Improvement	16.4	16.4	5.2
Support for Democratic Institutions	3.4	3.4	1.8
Human Resources Development	11.1	11.1	1.0
Improved Police Services (ICITAP)	13.2	13.2	6.4
Protection of Canal Watershed	10.1	10.1	0.1
<b>Program Design, Administration, Evaluation, and Audit</b>	<b>4.3</b>	<b>4.3</b>	<b>4.0</b>
<b>Grand Total Fiscal Year 1990</b>	<b>451.1</b>	<b>451.1</b>	<b>368.2</b>
<b>Percentage of Total</b>	<b>100.0</b>	<b>100.0</b>	<b>81.6</b>

Note: An additional \$10 million of Housing Investment Guarantee credits were made available, but not utilized, for replacement housing. These funds remain available to the Government of Panama for low-income housing programs.

GOP = Government of Panama; IFI = international financial institutions

# 2

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## The Private Sector Reactivation Program

**A**s submitted in PAAD 525-0304, dated July 12, 1990, the private sector reactivation program consisted of two components. The first component was designed to provide liquidity to the banks to encourage additional investment in the private sector. The second component was intended to assist any bank needing additional liquidity as a result of the planned unfreezing of time deposits. The second purpose was called the "safety net" provision; the first was referred to frequently as a means of "jump starting" the economy. Over time, before the program was launched, the emphasis gradually shifted from the safety net to the jump start component.

### Safety Net

The capital flight of 1987 and 1988 posed serious liquidity problems for the Panamanian banking system. By the end of 1989, the freeze on deposits introduced in 1988 had been only partially lifted. With a low level of liquidity, the banks rapidly reduced their loan portfolio, but the quality of the loans deteriorated as a result of the decline in business activity in general and

the looting of the inventories of many firms in particular.

The situation in Panama was further complicated because, unlike almost all other countries, Panama has no currency system of its own and, hence, no central bank to act as lender of last resort. Panama's reliance on the U.S. dollar as its monetary unit has, on the whole, served it well. Whereas other countries have used their central banks to print money to finance government deficits—and in the process have suffered all the distortions of inflation—the absence of a central bank forced Panama to stick to a noninflationary course.

Financial stability and the absence of exchange restrictions have also benefited the country by creating a favorable climate for the development of an offshore financial center, which has become an important source of employment in Panama over the last two decades. No one doubted that the fundamental strength that the country received from its reliance on the U.S. dollar should be maintained. Instead, the earliest thinking on an assistance program for Panama envisaged dealing with the question of illiquidity of the banking system (and per-

haps in the case of a few banks, insolvency) through the U.S. aid program.

These considerations induced A.I.D. to design a safety net and to set aside a portion of the funds available for Panama for this purpose. The \$108 million allocated for the safety net represented an inevitably rough estimate of the amount presumed necessary to support the freeing of deposits, and avoid (or if necessary meet) a run on some of the weaker banks, and encourage the banks to resume their lending activities sufficiently to expand the economy.

However, the developments in the early months of 1990, during which planning of the safety net proceeded and U.S. support for the Panamanian financial system became evident, made the likelihood of a run on the banks increasingly remote. The reflow of Panamanian money into the banks,

from returning capital and from mattresses, did much to relieve the banks' liquidity position in the first half of 1990. In addition, concerned by the impending unfreezing of deposits, the banks had hastened the reflow process by offering high interest rates, well above London Interbank Offer Rates (LIBOR), for deposits. The improved liquidity did not immediately lead to larger bank lending. The demand for credit was also weak, as borrowers remained concerned about the outlook for the coalition Government's new economic policy. In the first quarter of 1990, credit continued to contract somewhat (by about \$50 million); in the second quarter it increased by about \$70 million (see Table 2).

The fact that deposits increased—by almost \$230 million in the first half of 1990—before the freeze on time deposits was lifted was strong evidence that confi-

**Table 2. Panamanian and Foreign Banks, Loans and Deposits (US\$ million).**

	Loans			Private Sector Deposits		
	Panamanian Banks	Foreign Banks	Total	Panamanian Banks	Foreign Banks	Total
End of December 1989	805	1,298	2,103	699	753	1,452
End of March 1990	810	1,247	2,057	739	819	1,558
End of June 1990	839	1,282	2,121	800	880	1,680
End of September 1990	890	1,361	2,251	901	924	1,825
End of December 1990	954	1,366	2,320	997	987	1,984
End of March 1991	982	1,439	2,421	1,055	1,018	2,073
End of June 1991	1,049	1,449	2,498	1,144	1,049	2,193
End of September 1991	1,227	1,450	2,677	1,265	1,093	2,358
End of December 1991	1,386	1,471	2,857	1,441	1,199	2,640
End of March 1992	1,551	1,516	3,067	1,573	1,115	2,688

Source: Bank of Panama.

dence in the banking system had returned and that the unfreezing of deposits in early July 1990 would not entail any serious risk of a run on the banks. This judgment was confirmed by a careful study by the Comisión Nacional Bancaria (CNB) in April 1990. The CNB concluded that by that time the banks had enough liquidity to meet any demands for withdrawals that might result from lifting the freeze on time deposits (reported in PAAD 525-0304, p. 27).

These observations—reflecting in part Panamanian's certainty that the financial system would be safeguarded—made future claims on a safety net unlikely; but the evidence did not make a case for dropping the concept. The safety net thus remained as a second leg in the formal proposal for a private sector reactivation program dated July 12, 1990, 2 days after the Government of Panama had lifted the freeze on all deposits. The Government had rejected such intermediate solutions as unfreezing an initial 25 percent of deposits and lifted the freeze without waiting for the formal establishment of a safety net. The Government's courageous action turned out to be a complete success and, although the safety net came into effect 2 weeks later, there were never any calls on it. The nonuse of the safety net may also have been helped by the stiff terms laid down for its use: a penalty interest rate of 5 percent above LIBOR or 13 percent (whichever was the higher) and a deposit of assets equal to twice the emergency credit sought.

It should be added, however, that the widespread discussion of a safety net, as distinct from its actual creation in July 1990, was credited by many in the financial field as an important factor in the smooth

liberalization of deposits. More broadly, the January 25, 1990 announcement by the President of the United States of a \$1 billion support package for Panama, the emergency package of about \$41 million made available in February, followed by the action of the U.S. Congress in May authorizing an additional \$420 million, increasingly served to convince the people of Panama that the financial might of the United States was backing Panama's economic and financial structure. This feeling probably constituted a more important prop to the system than the specifics of the safety net.

## Reactivation of the Economy

As the probability of the need for a safety net receded, new ideas for the use of the money originally set aside for this purpose began to develop among Mission and Panamanian authorities: namely to reactivate, or jump start, the economy by extending credit to the private sector through loans to the banks. (The Mission's program for Panama as it stood in March 1990 had envisaged injecting liquidity into the banking system indirectly by rapid expenditure of funds by the Social Emergency Fund and keeping the safety net money in its entirety available for bank failures.) Although the banks' immediate liquidity problems had been lessened, banks were still not sufficiently liquid by the high standards they traditionally observed to resume lending on a scale required for a strong expansion of the economy. Also, the traumatic experience banks had undergone in 1987 and 1988 made them less willing to resume active lending in the form of medium- and long-term credits. Before 1987, banks had been willing to lend on such terms even though their deposits were mostly short

term. But the crisis years made them painfully aware of the resulting mismatch of assets and liabilities, when loans could not be reduced as rapidly as deposits were being withdrawn. Once burnt, the banks had by 1990 become more cautious and hesitated to greatly enlarge their medium-term portfolio unless they could obtain a strengthening of their medium-term deposits.

Initial plans for using A.I.D. money to provide medium-term finance (through, for example, cofinancing or various forms of rediscounting of bank loans) tended to suffer from a moral hazard in that they put official money at risk in the banks' investment activities. As ultimately worked out, however, these drawbacks were eliminated. A.I.D. resources were still funneled through the banking system to the private sector, but the loans were extended at the banks' risk not at A.I.D.'s or the National Bank of Panama's. With minor exceptions, both A.I.D. and the Government of Panama avoided the temptation of making choices that were properly those of the banks, such as to what firms or what industries or for what purposes money should be lent. This meant that A.I.D. money could not be tracked to particular expenditures in Panama or abroad, except in the most general terms, such as indicating the industrial breakdown of loans, which was quite broad, with heavy emphasis on residential and business construction, trade, and services (see Table 3).

The evaluation team believes that A.I.D.'s approach was correct. Providing additional funds to banks induces them to lend more. But to whom the banks lend should be their decision, unless the government is willing to bear part of the risk of the

**Table 3. Percentage Distribution of FREN-supported Loans by Economic Activities (percentage)**

Residential construction	23.3
Trade	22.5
Services	21.8
Manufacturing	17.3
Business construction	6.9
Agriculture	3.2
Husbandry	3.0
Pisciculture	1.8
Mining	0.2
Total	100.0

Source: Bank of Panama.

loans. Any rules about the direction of the additional funds have little if any effect on the actual direction of the total bank lending. Because money is fungible, banks can direct money from other sources for uses that the rules forbid. (As a matter of fact, consumer credit—the only major exclusion from eligible lending of the private sector facility—expanded rapidly in 1991 as banks found that such a facility freed their own resources for this purpose.) Moreover, if the banks had been pressured to actively pursue other aims in the use of Agency money, such as promotion of small businesses or credit to agriculture, the primary aim of giving a strong push to economic recovery would have suffered.

Knowing the technique used in these operations is important for understanding the economic function of the private sector facility. A.I.D. made \$108 million available to the National Bank of Panama, which used the money to buy certificates of depos-

its (CDs) from participating banks on presentation of packages of disbursed loans that met the terms of the private sector facility. The money was made available promptly by the National Bank of Panama; if ex post auditing proved (as it did in a substantial number of cases) that a particular loan did not qualify, the transaction was later reversed. However, CDs covered only 50 percent of the amount of the underlying loans. For purposes of A.I.D. accounting, the purchase of CDs was considered disbursement, and thus the end of the tracking of A.I.D. money. The main requirement for such loans was that they be medium term, between 1 and 5 years. Loans could be made for any economic activity (though not for consumer credit), with only a few exceptions for political and social reasons: Loans could not be made for military purposes, for abortion clinics, or for projects that could damage the environment. Loans had to be for *new* investments, not for refinancing investments made before mid-1990.

The Inspector General has raised a question about whether loans made after July 1, 1990, but before the lending bank had formally associated itself with the FREN program, could legally qualify for CD financing—assuming the loans met all the other requirements of the program. Although the evaluation team is not qualified to judge the legal merits of this issue, the Inspector General's question raises no significant economic issue. If, contrary to the practice followed by A.I.D., such loans did not qualify, the available FREN resources would merely have been spent slightly more slowly and more money would have been left at the end to satisfy pending applications.

The maturities of the CDs followed those of the underlying loans; most of the CDs were near the long end of the range; the modal maturity of those CDs outstanding in July 1991 was 50 months. The CDs carried a fixed rate of interest, based on the 6-month LIBOR at the time of the deposit and independent of the length of the deposit. The premium over LIBOR was initially set at 1 percent. In early February 1991, when FREN did not take off as rapidly as had been hoped, the premium was lowered to 0.5 percent; it was returned to 1 percent in July. For the Panamanian-owned banks, these were relatively low rates. In December 1990, Panamanian banks were paying 1.5 percent over LIBOR for 6-month CDs, 2.5 percent over LIBOR for 1-year CDs, and even higher premiums for such longer deposits as they could capture. The terms were not particularly attractive to foreign-owned banks, which typically paid interest rates close to, or even lower than, LIBOR.

The rate offered by FREN could be said to contain a subsidy for some of the banks because it was below what the banks would have had to pay in the international financial market. That market, however, was fragmented in the sense that a residual lack of confidence forced the Panamanian banks to pay premiums over the rates paid by foreign banks. FREN was correct in not charging the banks as high a premium as the market, both because of equity and because such a high premium would have limited the use of the private sector facility to the weakest banks and would have interfered with the objective of the program—the rapid expansion of bank lending.

Because the rate was at all times above LIBOR, the capital invested in the FREN

program gained at least some additional income above the yield available in world markets. (Some of the specifics of rate setting under FREN would need careful reconsideration if such a program were ever replicated, specifically, fixing the rate over time—the consequences of which are noted in footnote 3—and using the 6-month LIBOR as the base rate, whatever the CD maturity.)

FREN did not attempt to regulate the interest rate charged by banks for projects partially financed with FREN CDs. This approach seems to be a correct application of the principle that FREN was intended to stimulate bank credit, not regulate it.

How much stimulus to the economy—how much of a jump start—did this facility provide? To what extent was it responsible for the rapid (9.3 percent) growth rate of the economy in 1991? These questions break down into two parts:

- How much additional bank lending did the \$108 million disbursement produce?
- What was the contribution of this additional lending to the growth of Panama's GDP, both directly and indirectly?

### ***Impact of FREN on Bank Lending***

The grant agreement for the private sector reactivation part of the A.I.D. pro-

gram sets out in advance how the first question should be answered, indeed how the success of the program should be measured.

The effect on the banking system and on the economy must be measured by the medium-term effect of the total level of loans outstanding. Therefore, program success will be measured on the basis of the annual increase in loans outstanding to the private sector. The base line for comparison will be June 30, 1990 (Para B.3., "Grant Agreement Private Sector Reactivation Program," July 24, 1990).

This definition raises two issues. First, it attributes any increase in loans since the base date to FREN, as if no increase would have taken place in the absence of the program. Second, it appears to give FREN credit for the increase in any kind of loan, although only medium-term loans qualified for FREN support.

The second ambiguity may reflect a slip in the drafting of the grant agreement.<sup>2</sup> In applying the formula, Ambassador James H. Michel in his June 17, 1992 memorandum to the A.I.D. Inspector General refers only to the increase in medium-term loans by the banks since the base date. The actual figure he uses (\$415 million) also includes long-term loans (those over 5 years), which did not qualify for FREN

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<sup>2</sup> If so, it would not be the only one. Par. B.2.d. of the grant agreement states that "all private banks with general licenses will participate in the credit expansion subprogram, while only Panamanian private banks will participate in the liquidity subprogram." In fact, banks had the option of participating in the first program, but only some did.

**Table 4. Bank Loans and Deposits by Maturity  
(US\$ millions)**

<i>Banks Participating in FREN Medium- and Long-Term Loans and Deposits</i>				
<b>Loans</b>	<b>6/30/90</b>	<b>3/31/92</b>	<b>Increase</b>	<b>Percent</b>
1-2 years	75	154	79	105
2-5 years	131	336	205	157
More than 5 years	503	634	131	26
Total, more than 1 year	709	1,124	415	59
<b>Deposits</b>	<b>6/30/90</b>	<b>3/31/82</b>	<b>Increase</b>	<b>Percent</b>
1-2 years	63	129 <sup>a</sup>	66	105
2-5 years	94	190 <sup>a</sup>	96	102
More than 5 years	23	11	-12	-52
Total, more than 1 year	180	330 <sup>a</sup>	150	83
<i>All Private Banks, All Loans and Deposits</i>				
	<b>6/30/90</b>	<b>3/31/92</b>	<b>Increase</b>	<b>Percent</b>
Loans <sup>b</sup>	2,024	3,011	987	49
Deposits	1,680	2,688 <sup>c</sup>	1,008	60

<sup>a</sup>These figures include FREN CDs.  
<sup>b</sup>These figures differ from those in Table 2 in the exclusion of small amounts of loans to the public sector.  
<sup>c</sup>These figures do not include FREN CDs (\$90 million). See Table 5.  
Source: National Bank of Panama.

financing and perhaps partly for that reason increased by the smallest percentage of any category of loans.

The figures underlying Mr. Michel's appraisal, as provided by A.I.D., are presented in Table 4. For the reasons indicated, this study cannot accept these figures as measuring the effect (or the success) of the program, but the figures do shed interesting light on the development of the Panamanian banks during the period of the program. (The dates in Table 4 are those used on A.I.D.'s appraisal of the program. Actual

FREN lending took place almost entirely in calendar year 1991, as shown in Table 5.)

1. At the end of June 1990, when term deposits were still frozen, and in March 1992, when depositors and banks had adjusted their balance sheets according to their preferences, loans over 1 year were much larger than deposits over 1 year, and between the two dates such loans increased much more than such deposits (\$415 million versus \$151 million). Clearly, the banks in Panama, like banks everywhere, relied on the de facto continuity of short-



**Table 5. Use and Reflow of FREN Deposits  
(US\$ million)**

	1990		1991				1992
	September	December	March	June	September	December	March
1. CDs bought <sup>a</sup>	-	4.2	31.1	58.7	87.9	108.4	111.5
2. CDs repaid <sup>b</sup>	-	-	-	-	-	12.3	21.5
3. Net outstanding <sup>c</sup>		4.2	31.1	58.7	87.9	96.1	90.0

<sup>a</sup>Sum of lines 2 and 3. Exceeds \$108 million because of accumulated interest.  
<sup>b</sup>Reactivation account.  
<sup>c</sup>CDs in other banks.  
Source: Balance Sheet of National Bank of Panama.

term deposits to finance medium-term loans and mortgages. One bank, which did not accept any private deposits with more than 1-year maturity, explicitly stated this as its policy.

2. The total loans of all banks increased by nearly \$1 billion, compared with the increase by \$284 million of the medium-term loans of participating banks. Clearly, the banking system was in an expansionary phase that had preceded the start of FREN (loans had increased by about \$200 million in the second half of 1990) and continued after the end of FREN. The expansion was particularly strong in the Panamanian-owned banks, which accounted for more than 75 percent of the increases of both loans and private sector deposits in the banking system between June 1990 and March 1992.

3. FREN had a noticeable effect of slanting loans toward the medium term, especially the 2- to 5-year period during which the interest advantage was greatest. A very large proportion of these loans by participating banks (\$216 million out of

\$284 million) was supported by 50-percent FREN financing.

4. FREN also provided a very large proportion of the 1- to 5-year deposits that participating banks attracted: \$90 million out of a total of \$152 million.

However, for all the valuable information in Table 4, it does not answer the first question, namely, What was the effect of the program on the total amount of lending in the Panamanian economy? The answer depends crucially on the ease with which banks at that time had access to other sources of liquidity. Here, a distinction must be made between the Panamanian and the foreign banks. The foreign banks had, on the whole, access to the world's money markets, as is evident from the interest rates they paid; the Panamanian banks had generally no such access. The consequence of this was that FREN, although open to all private banks, was overwhelmingly used by the Panamanian banks. Panamanian banks accounted for more than 93 percent of the FREN CDs, even though they had only about 40 percent of the loans and one-half

of the private sector deposits of all private banks (end of 1990 data).<sup>3</sup>

Given the difficulty Panamanian banks had in accessing world money markets for resources, it is reasonable to assume that the full \$108 million provided under FREN led to additional lending. Even though some of the banks may have reduced their reliance on other sources of funds because of the availability of FREN funds, it would seem likely that these monies found other investment outlets in Panama. There would seem to be no reason to deviate from the standard assumption that a capital inflow of \$108 million financed by A.I.D. added that much to investment in Panama.

The question that might perhaps be raised is whether an initial injection of \$108 million into the banking system should not be assumed to induce banks to expand their deposits by, for example, three times that amount (assuming a monetary multiplier for Panama of about 3) and their loans by two times \$108 million. The answer to that question is that one cannot legitimately apply a money multiplier to an *initial* change in base money without taking into account the induced changes in base money—in this case in particular, the reduction resulting from the additional imports caused by the first round of investment spending and the

subsequent rounds of consumption spending, as discussed in the next section.

A.I.D. has suggested that, because banks had to submit loan contracts for \$216 million to receive \$108 million in CDs, the impact of FREN on investment was in fact \$216 million. That claim is based on the leverage implied in the 50/50 provision. But the concept of leverage, where one party conditions its contribution on the other party making a suitably matching contribution, does not apply in this case. True, in other settings an aid donor can multiply the impact of its contribution by conditioning it on a special effort by others, either the aid recipient or other donors. For example, A.I.D. may provide the pump only if the villagers put up the effort to install it. U.S. insistence on contributions from a Panama Support Group produced part of the money needed to pay off Panama's arrears to the international financial institutions. But in the case of FREN, no matching effort was requested from the banks. Collecting deposits and making loans is the regular business of the banks, FREN or no FREN. All that the banks had to do to get access to the special FREN CDs was to train their loan officers so that a large enough proportion of loans would qualify under FREN, and to fill out the necessary forms. The amount of lending the banks would be willing to en-

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<sup>3</sup> One U.S. bank told team members that it used only a small amount of FREN funds because, expecting a decline in LIBOR, it disliked the fixed-rate feature of the program. Another U.S. bank began as one of the largest users of FREN but agreed, as late as March 1992, to have most of its CDs, covering 106 out of its original 139 loans, canceled rather than disclose what it considered confidential client information; one may surmise that the decline in U.S. interest rates that took place during 1991 might have played some role in this decision.

gage in still would depend on the demand for credit and the supply of deposits, which FREN raised by \$108 million. All that the CD percentage ratio determined was how quickly the available FREN money would be disbursed.

Of course, the provisions of the facility may well have slanted the banks' lending toward term loans (see Table 4), but it is not obvious why this was an A.I.D. objective. The Program Assistance Approval Document spelled out the purposes of the loans to be promoted by FREN: "for investments in new plant and equipment, for construction, for mortgages for newly constructed buildings, or for incremental working capital" (p. 29). But no argument is presented for why loans for these purposes must also be between 1 and 5 years—why, for example, construction loans for more than 5 years would not qualify for FREN financing. It is not possible to conclude, therefore, that the concentration of new loans in this range was better for the economy or for employment than if the loans had been made with more conventional maturities.

### ***Impact of FREN on the Economy of Panama***

To arrive at an estimate—which at best can only be a rough one—of the impact of the FREN program on the growth of Panama's GDP, allowance will also have to be made for the large import component in both investment and consumption expenditures in Panama and for subsequent rounds of consumption as the income resulting from the additional investment is respent. This requires an estimate for a marginal import ratio and a marginal propensity-to-consume ratio. There is no model available

for the economy of Panama from which these coefficients could be lifted, but rough guesses might put the former ratio at 40 percent and the latter at 90 percent. This would produce a Keynesian multiplier of 2, which would lead to an estimated increase in GDP from FREN of \$125 million, or 2.5 percent of the total 1991 GDP (\$5.075 billion), when applied to an initial income round of 60 percent of \$108 million.

The relative contribution of FREN to total investment could be estimated as follows. Total private sector investment in 1991 was estimated at \$939 million. Without the extra funds supplied through FREN, investment might have been about \$830 million. Thus FREN can be credited with having raised private investment in 1991 by some 13 percent.

The figure for the effect of FREN on Panama's GDP can be used to estimate the effect of FREN on employment by applying the same percentage (2 1/2) to an employment figure comparable in scope to the sectors of the economy to which the bank credits were largely directed. Taking as the relevant estimate of employment the total employment outside agriculture and government (529,000), the effect of FREN on employment would appear to be about 13,000 person-years.

Although FREN and other stimuli (including a \$90 million swing in direct investment and a \$20 million increase in exports) had a positive effect on the employment situation, the overall unemployment rate declined only slowly from the high level reached in the crisis years (16.3 percent in both 1988 and 1989, as against 11.8 percent in 1987). No employment survey was conducted in 1990; the figure for 1991 stood at

15.7 percent and is estimated at 15.0 percent for 1992.

The contributions of FREN to growth and employment amply justified its costs (discussed later); there was certainly no reason to interrupt the program when it became evident during 1991 that the economy was on a solidly expansionary course. When the decision to continue FREN was made, this expansionary course was not as clear as it is now with the benefit of hindsight.

In his November 1991 report for A.I.D. on the FREN facility, Marco Fernandez estimated that economic growth in 1991 was not likely to be much higher than the poor performance of 1990, which would have meant that at the end of 1991 output would still be below the 1989 level (Fernandez 1991, 56). Moreover, switching to some alternative expenditure program would have involved delays that would have risked interrupting the tempo of the ongoing recovery.

In addition, in any appraisal of FREN, evaluators must examine the situation that existed in the first half of 1990, when the program was designed. At that time, there was little evidence of a robust recovery—an essential requirement for the political success of the Panama aid program. This justified the use of the \$108 million available in the program for the private sector to jump start the economy. In retrospect, the effect of the flow of money through the FREN program, which started in late 1990, was to strengthen the ongoing recovery. Apart from one essentially token operation with the Bank of Hong Kong, the Bank of Panama did not buy CDs from commercial banks until November 1990, and the total

amount it purchased in 1990 was only \$4.2 million.

With the restoration of confidence and the unfreezing of deposits in July 1990, the economy had turned upward from the middle of the year. During the second half of the year, private banks increased their lending, as mentioned earlier, by \$210 million. After a 16-percent decline in 1988 and an essentially flat 1989, the rate of growth of real GDP for 1990 was 4.6 percent, 9.3 percent for 1991, and, according to the latest estimates, about 8 to 9 percent for 1992. But because it is generally agreed that during the first half of 1990 little if any growth occurred over the 1989 level (although there was a recovery from the disorganization prevailing in December and January), the growth rate in the second half of 1990 must have been in the same range as that of the two following years. Nor is it particularly surprising that an economy like Panama's, having experienced the severe shock of U.S. sanctions and subsequent relief of massive U.S. financial support, would have a number of years of rather steep growth, after which it would presumably return to its sustainable growth path (projected at 5 to 6 percent for Panama).

### ***Use of Reflows From FREN CDs***

The discussion of the benefits of the FREN program to the economy of Panama needs to be rounded out by introducing a different dimension of the issue. The question of whether the portion of the A.I.D. program devoted to FREN was well spent is perhaps most accurately answered by stating that it was *not* spent. Rather, that component of the aid grant to Panama has been preserved for later use and in the meantime

has been invested in bank CDs. For accounting purposes, CD purchases may be registered as disbursement, but unlike the purchase of brick, mortar, and machines, the purchase of CDs does not represent a final disposition of the money. There is every reason to expect that the money will continue to return, with interest, and that only then will the Government of Panama finally disburse that portion of U.S. aid.

The reflow of aid money, once used, is not a new experience, but the form it takes in Panama is unusual. In countries that have their own currencies, the reflow takes the form of local currency balances, or counter-part funds, for example, as goods financed from aid dollars are sold in the country. In the typical receiving country with weak financial policies, the dollar value of these local currency balances may rapidly shrink as the currency depreciates. In most cases, A.I.D. has had little interest in supervising the use of these balances, since the receiving government could readily circumvent any restrictions applicable to the use of the balances by printing additional amounts of its own currency.

The situation in Panama is completely different. The reflow in Panama of the money invested in CDs is in U.S. dollars. To the extent that there is some loss in the purchasing power of the dollar, it is due to inflation in the United States, not to the lower inflation in Panama. It can thus be said that the reflows constitute a new aid program for Panama, ranging from \$32 million to \$12 million over the next 4 years (see Table 6). When the provisions on the handling of reflows were agreed on in 1990, this aspect of the reflow was not fully worked out. Under a provisional understanding—which might be changed by later

Table 6. Future Reflows From  
FREN CDs  
(US\$ million)

	1993	1994	1995	1996	1997
Capital	28.7	24.6	19.9	9.3	0.3
Interest	3.4	4.6	5.0	2.6	0.1
Total	32.1	29.2	24.9	11.9	0.4

agreement—the Government of Panama can use the money to repay nonmilitary debt to the U.S. Government.

Given that Panama's annual debt payments to the United States will be larger than the expected CD repayments, the true meaning of the understanding is that the reflow money becomes available to Panama as general budgetary support. This support will permit Panama to make a corresponding additional expenditure of its own choosing without a corresponding rise in taxes. This approach appears to reflect U.S. desire to avoid anything that might make the aid program seem intrusive.

Nevertheless, better ways could have been arranged for the release of the reflows into the Panamanian budget. One way would have been to provide in an agreement between the Government of Panama and A.I.D. that the funds could be used to finance projects not adequately funded in the budget. Alternatively, or in addition, the spending of the funds could have been made subject to some conditionality. The conditionality attached to the public investment program will end after the release of the third tranche. (Contrary to what the evaluation team had been led to understand during its October visit to Panama, A.I.D. recently decided not to release the last

tranche of the public sector program—in spite of the fulfillment of the stipulated release conditions—on the grounds that Panama had not complied with its program with the World Bank.) Given the importance that the Mission has attached to Panama continuing its program of structural adjustment as agreed with the international financial institutions, there would have been good reason to prolong the policy impact of A.I.D. money by making the use of CD reflows conditional on the country continuing to comply with the earlier reforms agreed to with the international financial institutions.

As far as the conditionality of the FREN program is concerned, the evaluation team shares A.I.D.'s position that U.S. interests in economic reform in Panama were sufficiently safeguarded by the conditionality attached to the use of the portion of aid devoted to public investment (see the discussion in Section 3) and that it would have been counterproductive to delay the availability of FREN until the conditions applicable to the release of the remainder of the \$420 million aid package had been fulfilled.

### ***Applicability of the FREN Approach to Other Countries***

As discussed previously, FREN made a substantial contribution to the growth of the Panamanian economy in 1991. However, the program did not become fully operational until late 1990, because it took A.I.D. considerable time to work out the particulars of the program in collaboration with the Panamanian authorities. What can be learned from this experience that might

be useful in future A.I.D. operations in other countries?

To answer that question, a number of country-specific aspects of the A.I.D. program for Panama must be considered. First, A.I.D. was called on, with little time for preparation, to mount a very large assistance program in Panama. Congress authorized the program in a specific law for that country. The Panama program, even in its absolute amount, was A.I.D.'s third largest, exceeded only by programs for Israel and Egypt. Beyond the amounts set aside for an array of specific objectives, the program contained from the start three subprograms (settlement of Panama's accounts with the international financial institutions, support for a government investment program, and reactivation of the private sector). Although the dollar amounts required for each of these subprograms could not be forecast precisely in early 1990, the total allocated among these three subprograms appears to have been frozen from the beginning in the same magnitudes communicated to Congress when the legislation was proposed.

A second unusual aspect of the operation in Panama was the deflated state of the economy. In a typical country where A.I.D. operates, the macroeconomic risk is almost always excess demand and inflation, not stagnation due to lack of demand and lack of credit expansion. In such cases, A.I.D., in accord with the International Monetary Fund (IMF), is concerned with limiting credit, not expanding it. In such countries, credit for the private sector may be inadequate, but excessive use of credit by the public sector (to finance government deficits) still makes it inadvisable to promote additional credit to the private sector until

the government's absorption of credit has been curtailed.

The third difference between Panama and almost all other countries—the fact that Panama does not have a central bank—turns out to be of less importance in this context. A central bank disposes of the technical means to stimulate larger credit by banks to the private sector, assuming the private sector has an unfilled demand for credit. The central bank can lower reserve requirements, open more generous rediscount facilities, lower its discount rate, and perhaps—if the financial market is well developed—engage in open-market operations. But the typical central bank in a developing country with balance-of-payments difficulties would not be justified in resorting to any of these techniques to stimulate the private sector unless it were assured of an additional supply of foreign exchange to meet the additional demand resulting from the credit expansion. On plausible assumption, that demand might build up in time to an amount equal to the credit expansion. Hence A.I.D. (if it were the source of foreign exchange support to the country) would have to provide as many dollars to backstop a policy of credit expansion in such a country as it would have to put up front in Panamanian conditions.

If A.I.D. becomes involved in another situation where a developing country requires a stimulatory policy and A.I.D. has the resources to backstop such a policy, the Agency should make its assistance conditional on a sound scheme for the credit expansion. In the case of Panama, the long deliberations with the Government produced such a plan. In general, however, governments that have tried to channel additional credit to the private economy,

whether through the central bank or otherwise, have had very uneven results.

One approach to directed credit—government intervention in credit allocation—is rediscounting by the central bank of certain categories of commercial bank credit. Its equivalent in the FREN scheme is the purchase by the central bank of commercial bank CDs linked to categories of commercial bank credit. Sections 4 and 9 of the *1989 World Development Report* of the World Bank provide an extensive analysis of this widespread practice. Three other approaches have also frequently been used: (1) nationalization of banks to give governments direct control over at least part of the credit flow; (2) regulations governing distribution of bank or other private financial intermediary credit by sector or industry, including rules on the maximum rate of interest to be charged to certain protected borrowers; and (3) creation of development finance institutions specifically to provide long-term finance to particular sectors.

In part, these various forms of directed credit aimed at correcting a serious weakness in the countries' financial structure: the absence of (to all but a few privileged borrowers) medium- and longer-term credit (and sometimes of any credit) at reasonable interest rates. Frequently, however, the aims have been more questionable: to provide cheap credit to state enterprises or politically important groups to offset the effect of an over-valued exchange rate and restrictive trade practices. As a result, directed credit schemes in many countries have not corrected the inadequacies of financial markets, but have resulted in new distortions in these markets and have bestowed subsidies on favored groups of borrowers.

As was mentioned previously, the FREN program in Panama avoided almost all of the negative aspects of directed lending commonly experienced in other countries. The main aim of FREN was to add to the supply of loanable funds, not to redirect it. The program allowed banks almost complete freedom with respect to the loans that could be refinanced under it, thus making for at most very minor distortions. The program contained no element of cofinancing or credit guarantee by the Bank of Panama; it was entirely clear that the commercial banks would have to repay the CDs on their due dates, whether their debtors paid on time. The interest rate, at slightly above LIBOR, contained no subsidy as far as the Bank of Panama or the ultimate beneficiary, the Government of Panama, was concerned, although it was clearly advantageous to Panamanian-owned banks. The advantage was not so great, however, that discontinuing the scheme in mid-1992 posed any great difficulty.

It would appear that the Panamanian authorities were as anxious as the USAID Mission to avoid the negative experiences of other countries with programs of directed credit. In the future, however, the cards might not be stacked so favorably. If another case presented itself whereby A.I.D. money was to be used to underwrite a policy of credit expansion, the Panama program would serve as a good example because it avoided most of the risks of directed credit. Future programs designed to stimulate bank lending by adding to the banks' liquidity should emphasize the liquidity aspect of the program and be wary of imposing limitations on the purposes or the terms of bank lending. Program designers should realize that any such limitations on the use

of part of a bank's resources are likely to have only a limited impact on the bank's lending portfolio as a whole.

There is a further lesson to be learned from A.I.D.'s experience in Panama. As mentioned earlier, the plan in early 1990 was to inject liquidity into the banking system indirectly, by quickly disbursing aid through the Social Emergency Fund. Such an approach might appeal to program designers because it appears to provide two benefits for the price of one. Unfortunately, that option is not available. Social expenditure may be as effective (or perhaps even more effective) in creating income as is the provision of funds to the banking system for expanding lending. Although some of the money spent on social programs, and repaid by those who receive it in further income rounds, will pass through the banking system, the money will not stay there; therefore, it will not provide the banks with a solid deposit base on which to extend more credit.

In a wide open economy such as Panama's, a substantial proportion of each income round will be spent abroad. Consequently, most, if not all, of the dollars spent on social programs will leave the country as payments for additional import; they will not stay in the banks. Of course, the same can be expected to happen to dollars made available directly to the banks, for example, through the FREN program. The point is not that one approach is in general better than another, but that each approach can achieve only one end. A choice will have to be made between spending money on social projects or on additional bank-financed investment, with the knowledge that repayment of the bank loans will, in due course, permit another round of spending.



## The Public Sector Investment Program

One of the worst casualties of the squeeze on government finance in the crisis years of 1987-1988 in Panama was public investment, and it took a long time to reverse the trend. As a percentage of GDP, public investment had been around 5 percent in the mid-1980s. It declined to 3.7 percent in 1987, 1.5 percent in 1988, and 1.4 percent in 1989. It declined even further in 1990—to 1.1 percent—and made only a modest recovery in 1991 to 2.4 percent.

There were several reasons for this slow recovery. Even under the new Government, the budget resources available for public investment remained constrained; moreover, it took a major effort, after years of cronyism and corruption, to reinstitute proper budgeting controls, bidding practices, and auditing to bring official spending under democratic control. The radical change in the way public investment expenditure was handled resulted in very few projects becoming ready for financing in

1990, and the slowdown in the project portfolio stretched well into 1991.

### Need for a Public Sector Investment Program

The backlog in public sector investment that had developed in the crisis years made the public sector investment program (PSIP) a natural element in A.I.D.'s recovery program for Panama. PSIP funds were used for priority investments in agriculture; health, education, justice, and other social sectors; natural resources; and infrastructure. Out of the total available (\$113.9 million), \$20 million was channeled through the Social Emergency Fund to many small, labor-intensive, local social development programs.

However, as the new Government of Panama was fully aware, for the economy of Panama to grow at a healthy pace, it was not enough to improve infrastructure and replace worn-out equipment of state enter-

prises. Equally essential was removing the structural impediments to growth that prevented the launching of a lasting economic expansion. These structural weaknesses included the following:

- Excessive employment in the public sector
- Inefficient operation of public sector enterprises
- Inadequate public investment and maintenance, leading to a poor state of public-sector services ill-suited to serve a rapid recovery in the private economy
- A tax system that discouraged investment and the use of labor
- Very high trade protection aimed at import substitution and self-sufficiency in food, a particularly ill-advised approach for a country with a very small domestic market and with a comparative advantage that clearly is in the provision of services
- Extensive price controls in support of protective trade and agricultural policies
- An overregulated labor market
- An underfunded and overly generous social security system
- Technical insolvency of four public banks and a weak regulatory and supervisory framework of the commercial banks

In addition to these chronic economic weaknesses, poverty had increased in the second half of the 1980s, necessitating urgent attention to a wide range of social issues. Structural change was, accordingly, the central focus of the World Bank and the Inter-American Development Bank (IDB)

in their relations with Panama. These two organizations linked their loans through conditionalities to progress made in changing the structural weaknesses listed above. Moreover, Panama had no option but to apply for new loans from the World Bank and the IDB because, even with the aid promised by the United States and other donors (as later discussed), it did not have enough money at its disposal to pay off the arrears to the international financial institutions. The position of the World Bank, the IDB, and the IMF was that, before any one of them made a new loan to the country, the arrears to all should have been paid off. In this way, Panama's understanding with the World Bank and the IDB on a program for structural reform became an indispensable element in regularizing the country's arrears to the three financial institutions and in obtaining new credit from the IMF.

### Conditionality for the PSIP

A.I.D. made the release of the second and third tranches under the PSIP program also conditional on Panama's progress in its negotiations with the three financial organizations. The release of the first tranche—which took place in October 1990—was made conditional not on action taken by Panama in structural reform, but on the submission of specific plans for action in the subsequent period. These plans covered the following broad fields:

- Management of public sector finances with respect to revenues, expenditures, salaries, savings, reduction of external debt, and investment.
- Identification of the first public enterprises to be privatized and a plan to implement these privatizations. Five

enterprises were identified for this purpose.

- Lowering of tariffs, elimination of quantitative trade restrictions, and reduction of the number of products subject to price control.
- Improvement in the competitiveness of Panamanian products on world markets.

Given the broad nature of this structural "menu" it would have been unrealistic to expect the new coalition Government with limited personnel resources to make rapid progress in every area in its first year in office. Accordingly, the program's focus on careful planning on a broad canvas, rather than on quick action on a few immediately feasible measures, was appropriate. Given the inevitable delays on the part of the Panamanian authorities, this planning process, which took about 10 months, did not unduly delay making resources available for actual expenditure. To have insisted on widespread structural action would have had that effect.

The critical condition for the release of the second tranche constituted a direct link with Panama's negotiations with the World Bank and the IDB on a program of structural reform. (A.I.D. documentation refers to a "program of economic reactivation," but this is a misnomer; by the time the second tranche was released in January 1992, the economy had long been reactivated and the contents of the program agreement with the World Bank and the IDB focused on means to raise growth over the medium term, not on immediate stimulation.) Two other conditions for the release of the second tranche did not prove binding: agreement with the United States on meas-

ures to limit the laundering of narcotics money and acceptable progress in implementing policy reforms in public sector finances, privatization, labor policy, and trade and commercial policy. The first condition had been met in July 1991, and agreement with the financial institutions implied that a reasonable list of such progress could be presented.

The release of the third tranche was similarly attached to Panama's relations with the international financial institutions, namely, the receipt of first tranches of assistance from the World Bank and the IDB in support of the medium-term economic reactivation program. Panama received the first \$60 million from the World Bank in July 1992 and the first \$50 million from the IDB in September 1992, whereupon A.I.D. was set to release its third tranche in October 1992. (Although the formal A.I.D. conditions for the third tranche included evidence on reasonable progress similar to that requested in the second tranche, there is no evidence to suggest that this was intended as a binding condition. Nevertheless, A.I.D. held up its third tranche until the World Bank and the IDB released their first tranches.)

The conditionality of the World Bank and the IDB covered in considerable detail all areas of structural deficiencies listed previously. Many of these weaknesses were also covered in A.I.D.'s list of items to be dealt with in the 1990 planning phase of its own program. Given the close cooperation between A.I.D. and the international financial institutions, in Washington and in Panama, this could only have been expected. It should be noted, however, that for the World Bank and the IDB, release of their first tranches did not signify full satisfaction

with Panama's policies for structural reform. In fact, release of the second tranche of the World Bank loan, which had originally been expected in fall 1992, is likely to be delayed until some time in 1993, depending on the progress by the Government of Panama on trade liberalization, further reduction in official employment, and privatization of the telephone company. It is still too early to judge whether Panama's performance will qualify it to receive the second or later tranches of the IDB loan.

The two-stage linkage of the release of A.I.D. money to the Government of Panama's performance (i.e., releasing the last tranche of A.I.D. money after the World Bank and the IDB released their first one) implies that A.I.D. could not have the same assurance as those institutions that its money would buy the hoped for structural adjustment. Despite this drawback, the evaluation team believes that A.I.D. applied a proper degree of conditionality. First, it was appropriate for A.I.D. to attach its conditionality to that of the World Bank and the IDB rather than to design a conditionality of its own. A separate A.I.D. conditionality—whether more lenient, harsher, or simply different from the two institutions'—would only have caused confusion in Panama about what policy elements Washington considered essential.

At the same time, A.I.D. acted wisely in designing its disbursements in a somewhat different time frame from that of the World Bank and the IDB. The PSIP had an economic and political importance of its own, which properly carried a somewhat greater weight in A.I.D.'s considerations than in those of the international financial institutions. Moreover, A.I.D.'s high profile association with Panama was intended

to be short lived, which meant that A.I.D. could not stretch its disbursements over as long a period as the World Bank or the IDB could.

As it turned out, the cautionary process of Panama's investment planning referred to earlier meant that even if the funds from the first tranche had been released earlier, they probably could not have been spent. The general expectation in the fall of 1990 was that all the elements necessary for the settlement of arrears with the three international financial institutions would fall into place within a few months, permitting the early release of A.I.D.'s second tranche. Panama's difficulties in meeting the many components of the World Bank's conditionality package—difficulties that would take too long to analyze—unexpectedly delayed release of A.I.D.'s second tranche by about another year. This delay produced a hiatus of about 3 to 5 months between Panama spending the first tranche and the availability of the second tranche—a consequence that A.I.D. would have preferred to have avoided.

It should be emphasized that in a case such as this, where the amounts to be lent by the international financial institutions were a multiple of the resources to be provided under the PSIP, A.I.D.'s primary purpose for associating itself with the conditionality of the international lenders is not to add weight to that conditionality, but to make clear to the client country that A.I.D. fully endorses and gives its moral and financial support to the policy changes recommended by those institutions. Under the conditions prevailing in Panama, that position could hardly have been in doubt. With the new Government critically shorthanded to deal with the many requests coming from

the international financial institutions, it fell to the USAID Mission to act as the conditionality expediter. With a larger continuous presence than any of the financial institutions, A.I.D. could assist the Government of Panama in its search for measures that would satisfy the requirements of the lending institutions in the face of the country's many administrative and political constraints. Without A.I.D.'s help, agreement might have taken even more time.

In a setting such as in Panama, A.I.D. could gain more flexibility, without undermining the force of the conditionality of the international financial institutions, if it spells out in advance what circumstances

will allow the release of some part (e.g., one-half) of each tranche before the stipulated conditions are met. In Panama, these circumstances could have been the following: (1) if the conditions stipulated for the release of the tranche were unexpectedly delayed and (2) further delay in the release of the tranche would risk serious harm to the orderly execution of the program. Such provisions would have to be specified in advance, however, because any later loosening of A.I.D.'s link to the conditionality specified by the international financial institutions would inevitably be interpreted as a signal of its disassociation from the merits of the conditions.

## Settling Arrears With The International Financial Institutions

**D**uring the crisis years, Panama failed to make the required payments (interest and amortization) to the international financial institutions—IMF, World Bank, IDB, and, for a small amount, the International Fund for Agricultural Development; it also defaulted on its bonds and its credits from commercial banks. After the change in government, it was a matter of first priority to reestablish Panama's position with the international financial institutions, from which it could then expect to receive considerable amounts of credit.

During the planning stage, A.I.D. developed the following approach to alleviating Panama's credit problem. At the end of 1989, Panama's debt to the international financial institutions was approximately \$540 million. The total amount would have to be settled in a single operation (executed within a few weeks) because each institution required settlement with the other two before it was willing to extend new loans; and without new loans, Panama would be unable to settle. Loans from the international financial institutions would be disbursed in installments, but, for purposes of

settlement, Panama would be able to use only the first installment from each loan issued by the institutions, estimated at about \$150 million in total. The United States was willing to provide a bridge loan for this amount, which would reduce Panama's need for immediate cash to \$390 million. The United States envisaged splitting the \$390 million in three equal parts. Panama would use \$130 million of its own money (for this purpose, that amount was separated and put into escrow when the freeze on Panama's balances was lifted); the United States would put in an equal amount from its A.I.D. program funds for Panama; and other countries would be asked to provide the third \$130 million. The latter would be contributed in a manner similar to that used in a few other cases where countries needed assistance in settling large arrears to the international financial institutions.

In the application of this approach, three developments radically changed the expected outcome:

- Although Panama reached agreement with the IMF in September 1990, negotiations on new credits (and the attend-

ing conditions) from the World Bank and the IDB took much longer because Panama encountered difficulties in taking the prior actions that these institutions required. As a result, the settlement of arrears dragged on until early 1992.

- Because much of Panama's debt to the international financial institutions was in currencies other than the U.S. dollar, the gradual depreciation of the dollar in the 2 years since the end of 1989 raised the dollar value of that debt to \$658 million.
- Neither the European countries (except France, which made a grant of \$3 million) nor Canada proved willing to join the support group. Japan and Taiwan contributed in the form of loans to cofinance World Bank and IDB loans.

The net result was that even though the initial disbursements of the new loans by the international financial institutions were

brought to \$188 million, Panama's own contribution needed to be raised by \$118 million, according to World Bank calculations. Since all but \$133 million contributed by the United States and France was in the form of loans at market interest rates, it would probably be more accurate to say that Panama paid \$555 million to settle its arrears, \$248 million in cash and the rest by borrowing from the international financial institutions, Japan, and Taiwan.

U.S. conditionality for the release of the \$130 million in A.I.D. money for the settlement of arrears was directly linked to the conditions posed by the three international financial institutions for the release of the first tranches of their respective new credits to Panama. Since the purpose of this component of U.S. aid was to facilitate settlement with the financial institutions, that linkage of conditionality was, in our view, entirely appropriate.

# 5

## A.I.D. Program Planning

The primary concerns of the evaluation team, in the limited time available, were the economic effects of the A.I.D. program on Panama and the conditionality applied to obtain the greatest long-term beneficial impact from A.I.D.'s intensive association with Panama in the 1990-1992 period. Our study of Panama during that period also gave us an opportunity to observe the planning technique of A.I.D. in this case.

The program for Panama had to be organized in an extremely short time, in the wake of a military operation, and without full knowledge of the economic situation in the country or of the economic policies of the new coalition Government. At the same time, the situation not only made emergency action, but also the announcement of a broad program of economic reactivation, politically urgent. Moreover, the program required special congressional action, which in turn dictated a set of specifics (e.g., specific indications of program size and composition), leaving A.I.D. less room to respond to developments. A particular drawback was that the private sector reactivation program did not become operational until the fall of 1990.

At various points, A.I.D. had a choice between becoming directly involved in investment decisions in Panama or leaving those decisions to the market (for the private sector program) or the Panamanian Government (for the public sector investment program). In both cases, A.I.D. correctly chose against exercising excessive paternalistic influence on the course of the Panamanian economy. The criticism these choices provoked—that A.I.D. did not know what happened to the money provided—is fundamentally wrong. It is based on the assumption that A.I.D. knows better than the banks in Panama what are good investments in the private sector or than the Government of Panama what are the most urgent investment needs in the public sector.

The principle of a modest A.I.D. staff involvement also accounted to have for the decision the FREN program be run by the Bank of Panama, not by A.I.D. The evaluation team did not conduct an intensive study of the actual operation of the FREN program, but from what it witnessed and what it heard about the program from commercial banks, the team fully supports A.I.D.'s choice on this issue.



As mentioned earlier, A.I.D. did not outline its own set of conditionality criteria for the release of installments of its various programs. Instead it adopted certain benchmarks in Panama's conformance with conditions set by the international financial institutions. This choice economized A.I.D. work in an area of decision-making for which the international financial institutions are better equipped, but the primary advantage of the approach was that it

avoided confusing the Government of Panama about the adjustment priorities of A.I.D. and the financial institutions. The approach did not mean that A.I.D. neglected the need for structural adjustment in Panama. On the contrary, the approach helped emphasize the importance of common requirements in this area and helped a new and understaffed Panamanian Government in its efforts to reach the structural objectives that it also shared.

# 6

## Lessons From the Panama Experience

**T**he setting for the A.I.D. program for Panama was in many respects unusual. For example,

- The program immediately followed a military operation, leaving limited time for observing the country's needs and planning how to meet them.
- Panama's per capita income (in the range of \$2,000) put the country outside the normal scope for high-intensity A.I.D. assistance.
- The absence of a Panamanian central bank and currency—the complete reliance of the Panamanian economy on the U.S. dollar—gave Panama a financial structure radically different from that normally encountered in aid-recipient countries: full convertibility, a high-quality banking system, and, perhaps most important, the inability of the Government to finance a budget deficit by inflationary means.

These differences indicate that much of the experience gained in Panama is country specific and of limited relevance to other countries.

Nevertheless, a number of lessons, summarized below, seem potentially appli-

cable to a wider range of countries and thus deserve attention.

1. If lack of demand is the problem in an aid-recipient country, A.I.D. can use part of its resources to overcome this deficiency, either by sponsoring a fast-disbursing domestic program or by pumping additional resources into the banks, thus inducing them to step up lending. It cannot be expected that a domestic spending program will also improve the liquidity or the tempo of bank lending.

2. If A.I.D. chooses the second alternative (e.g., because of severe unemployment), it should not assume any risks from the bank loans. The CD approach used in Panama met that test. The corollary of this approach is that the recipient-country government should leave the choice of debtors, terms, and projects overwhelmingly to the banks and resist the temptation to use the A.I.D. program to pursue a variety of other objectives.

3. A.I.D. may supply a grant to the recipient country, but funds supplied to the banks in support of their lending activity should return to the government as the loans are due for repayment (even if the borrower

fails to repay). A.I.D. should consider this reflow as a new aid program to which it can suitably attach some degree of conditionality—the more so if the original "disbursement" to the banks was made without conditionality in order to expedite the process.

4. In countries where the programs of the international financial institutions carry a broad spectrum of conditionality that coincides substantially (if not in every detail) with A.I.D.'s objectives in structural adjustment and the resources of the financial institutions are a multiple of that of A.I.D., the Agency should not specify its own conditionality. Rather, it should piggyback onto suitably selected release conditions of one of the financial institutions.

5. In such a setting, A.I.D.'s support of the conditionality of the international financial institutions is primarily moral rather than financial; it is therefore appropriate for A.I.D. to exempt from this conditionality certain subprograms or portions of programs that it considers too urgent to delay, as in the case of the private sector reactivation program in Panama, which was already late when it went into effect in the

fall of 1990. A.I.D. might also have taken similar action for some portion (e.g., one-half) of each of the three tranches of the public sector investment program, provided the Agency had specified in advance the circumstances under which such action could be taken.

6. Finally, the experience in Panama shows the drawbacks of a rigid program that is tightly allocated long before the magnitude of the country's needs or the contributions from other sources can be defined. Such drawbacks in Panama did not originate with A.I.D.; rather, they were associated first with the political process of high-level interagency decision-making about a program that the U.S. Government could support and second with the process of piloting this program through Congress. Consequently, any remedial action in a similar program should be taken at these earlier stages, before A.I.D. is given a program to administer. Nevertheless, in such a situation it is up to A.I.D. to wield all its influence at the design stage to ward against any undue rigidity in the emerging program.

# Appendix A

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## Statement Of Work

### Issues

The rationale for some components of the Agency for International Development (A.I.D.) assistance program for Panama, and the assessment of the overall economic impact of the program, has raised the following issues.<sup>1</sup>

- Was the overall program conceptually sound in view of the immediate problems facing the economy?
- Did the program provide an appropriate balance between short-term and long-term measures?
- Was program implementation adequate for achieving both short and long-term measures?
- Did the short-term stabilization program contribute to the economic recovery?
- Did the rate of disbursement for both short- and long-term measures affect the success of the various programs?
- Did the program help alleviate the lot of low-income population groups that suffered as a result of Operation Just Cause and related events?
- What were the most important program elements that provided the basis for sustained growth and development?
- How effective was A.I.D.'s administration of the foreign assistance program in Panama? Did A.I.D. establish appropriate and consistent benchmarks for disbursement of funds?
- Were there serious administrative problems that caused disbursement delays? How well did the Government of Panama meet the policy and institutional reforms agreed upon? Were there differences with Panama in agreeing to and determining whether conditions

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<sup>1</sup> The controversy revolves around technical points made in reports by the office of A.I.D.'s Inspector General and, more recently, in press accounts of a draft report by the U.S. Government Accounting Office (GAO). The GAO report had not been submitted to A.I.D. at the time this scope of work was prepared. The GAO report was legislatively mandated.

were achieved? If the pace of Panamanian reforms did not meet expectations, did A.I.D. take the appropriate steps to ensure compliance?

- Did the information available to the planning team indicate that immediate action was necessary in the banking sector to improve liquidity and promote medium- to long-term private sector investment? Was there a "crisis in confidence" that prevented the banks from carrying out their normal accreditation activities? Was concern about the threat of a run on the banking system justified?
- Did emphasis on the banking sector compromise actions in other sectors that could have provided a greater amount of short-run benefits to the economy?
- What have been the economic impacts of the A.I.D. assistance program?
- Did the injection of the \$107.8 million raise the level of private sector term investment? What are the channels through which the increased liquidity to the banking sector shows up in the economy? How can the economic impacts be measured?

## Evaluation Team Tasks

The team will provide a report to the contract officer that addresses the issues specified above, as well as other related issues raised in the press, the A.I.D. Inspector General's Report on Panama, and in a forthcoming GAO report (if it becomes available during the conduct of this evaluation). In the report, the contractor will specify appropriate indicators, both quantitative and qualitative, to assess and measure

program impacts. The analysis will discuss whether the A.I.D.-administered assistance package

- Was appropriate to the economic circumstances in Panama and the mandate of the Administration and the Congress
- Was founded on sound economic reasoning and evidence
- Served U.S. interests well
- Was adequate in terms of the political context in Panama

Likewise, the analysis will evaluate program implementation bearing the same issues in mind. Moreover, it should address whether alternative program designs or implementation modes could have been more effective as circumstances in Panama changed during 1990 and 1991.

Based on its analysis of the Panamanian experience, the evaluation team will present recommendations regarding the most desirable future courses of actions, for economic assistance, under conditions similar to those of Panama in 1990 and 1991.

In such light the evaluation team will explicitly address in its analysis the questions relevant for the objectives of the evaluation, the issues raised above, and the tasks just mentioned. A nonlimiting set of questions follows; the analysis will address them, as well as any other question implicit in this scope of work. In addressing the questions, the analysis will elaborate on the theoretical and empirical foundations for its conclusions, indicate the lessons learned, and make clear recommendations for alternative action courses as appropriate.

## ***Program Design***

Taking into account the political and economic contexts, was the program well grounded on correct analysis and realistic in terms of goals and implementation means?

In connection with program design, was there adequate balance between short- and long-term goals? Did the state of the economy in 1989 warrant the level and mix of programs recommended by the planning team?

Did A.I.D. react in a timely and effective way to changing circumstances in Panama? Did the amount of funding available for Panama affect the balance between short-term stabilization and removal of the obstacles to long-term development?

On the funding for private sector reactivation, was the need for additional liquidity in the banking sector a correct response, given the perception of a potential run on the banking sector after the elimination of controls on deposits and the installation of the Government? Once the threat of a run on the banks diminished, was the continued injection of dollars in the banking sector appropriate?

Given conditions in the banking sector and the Panamanian economy, was the concept of providing funds to influence the term profile of loans sound? What was the impact of such funding on term investment? Was the mechanism under which the funding took place appropriate to influence additional term investment?

## ***U.S. Government Planning***

In view of the difficulty involved in negotiating with a fragile, newly established Government, in a context where the legislative and the executive were fragmented, and in a country with a tradition of corruption in much of the public and private sector, was the internal decision-making process in the U.S. Government adequate to ensure that

- The funds met their objectives
- The opportunity costs of pursuing the program objectives remained reasonable?

## ***Disbursements***

Did A.I.D. exercise adequate leadership in connection with the allocation of funds and speed of disbursement? Did Washington provide appropriate and timely guidance on difficult policy issues?

Were the conditions agreed upon with the Government of Panama for the disbursement of the economic recovery assistance package adequate for achieving program objectives? Was A.I.D.'s role in discussing the conditions and in its interaction with other international funding agencies appropriate to the circumstances? If disbursement of the funds relating to helping the Government of Panama settle arrears with the international finance institutions took longer than anticipated because of lack of agreement with other international organizations, did A.I.D. act appropriately by withholding disbursement? Could a more effective course of action have been taken? Once the disbursement took place, what was its impact?

## ***Economic Impacts***

Did the program have the desired macroeconomic impact on the Panamanian economy? What evidence exists, if any, that the growth in the Panamanian economy over the past 2 years would have occurred in the absence of the A.I.D. program? How much of the 4.6 percent and 9.3 percent real gross domestic product growth in Panama in, respectively, 1990 and 1991 was due to the U.S. foreign economic assistance?

Did the program subcomponent designed to strengthen the public sector investment budget accomplish its intended objectives effectively and in a timely way? What was the impact of these funds?

Did the emergency needs assistance program effectively reach its target population groups in a timely fashion?

Did the increase in liquidity resulting from the banking program provide a basis for new activity in the private sector? What evidence is there to suggest that a primary catalyst was the A.I.D. program of providing additional resources?

## **Methodology**

To meet evaluation objectives and to address and answer all issues and questions raised in this scope of work, as well as other relevant issues or questions, the evaluators will work as a team making use of the comparative advantage of each team member.

As appropriate, the evaluation will build on the application of standard economic theory and quantitative and qualitative methods to the issues at hand. In all

aspects, the evaluation will take into account the political context—both in what relates to internal conditions in Panama, as well as U.S. interests as reflected in the relevant legislation and public statements.

The gathering of needed information will take place through review of pertinent documentation in Washington and Panama, and interviews with relevant U.S. Government and Government of Panama officials, private sector representatives in Panama and in the United States, and meetings with officials in other funding institutions.

## **Deliverables**

The evaluation team will present a written report which covers all the points mentioned in the preceding sections and which meets the objectives of the evaluation, no later than 40 days after the contract start date. Prior to the submission of the final version of the report, the contractor will submit to A.I.D.'s Center for Development Information and Evaluation a complete draft of the report and allow up to 10 working days for comments from A.I.D. prior to the submission of the final version.

In addition to the written report, the evaluation team will provide oral briefings to A.I.D. and other interested officials on the main findings of the report. The briefings will take place on A.I.D. premises or in designated locations.

## **Schedule**

The evaluation team will start its work immediately after the outside contractor formalizes an agreement with A.I.D. The schedule calls for

- Three to five working days in Washington for document review and consultations
- Up to 10 working days in Panama for document review and consultations

- Up to 3 weeks back in the United States, preferably in Washington, D.C., for the final report preparation and the oral debriefings

The contract completion date is January 31, 1993.



# Appendix B

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## Persons Interviewed

### A.I.D./Washington

Craig Baier  
Desk Officer

Juan J. Buttari  
Policy Directorate, Center for Development  
Information and Evaluation

John Eriksson  
Director, Policy Directorate, Center for De-  
velopment Information and Evaluation

James Fox  
Policy Directorate, Center for Development  
Information and Evaluation  
(Former Chief Economist of the Bureau for  
Latin America and the Caribbean )

Cressida McKean  
Policy Directorate, Center for Development  
Information and Evaluation

James Michel  
Assistant Administrator  
Agency for International Development, Bu-  
reau for Latin America and the Caribbean

Mary Ott  
Bureau for Latin America and the Carib-  
bean, Chief Economist  
(Former Panama Mission Economist)

Thomas Stukel  
Mission Director

USAID/Philippines  
(Former Mission Director for Panama)

### Government of Panama

Aurelio Barria  
Executive Director  
Social Emergency Fund

Mr. Rubén Darío Carles  
Controller General

Ernesto Boyd  
Panama National Banking Commission

Guillermo Ford  
Vice President

Leg. Milton Henriquez  
Legislative Assembly

Miguel A. Lee  
Deputy General Manager  
National Bank of Panama

Juan Luis Moreno  
Adviser to the Ministry of Planning

Luis H. Moreno  
General Manager  
National Bank of Panama

Luisa de Soto  
Director  
Ministry of Planning

## **International Financial Institutions**

John M. Abbott  
Adviser to U.S. Executive Director  
International Monetary Fund

Yalcin M. Baran  
World Bank, Washington  
(Former Panama Embassy Economist)

Leonardo Cardemil  
International Monetary Fund, Washington,  
D.C.

Judith Gold  
International Monetary Fund, Washington,  
D.C.

Luis Sánchez Masi  
Inter-American Development Bank,  
Panama

Moazzam Mekan  
World Bank, Washington

Felix A. Quiros  
Adviser to Executive Director  
International Monetary Fund

Fred Schiek  
Inter-American Development Bank  
(Former Deputy Assistant Administrator  
for A.I.D./Bureau for Latin America and  
the Caribbean)

Milan Zavadjil  
International Monetary Fund, Washington,  
D.C.

## **Other U.S. Government Officials**

Daniel E. Coates  
Economist, Office of the Chief Economist  
U.S. General Accounting Office

John Dawson  
Director, Office of Panamanian Affairs  
U.S. Department of State

Hon. Deane R. Hinton  
U.S. Ambassador to Panama

Donald L. Patton  
Assistant Director  
Foreign Economic Assistance Issues,  
U.S. General Accounting Office

## **Panamanian Private Sector Representatives**

Raúl Alemán  
General Manager  
Banco General

Ricardo Alfaro  
Banco Nacional de París

Nicolás Ardito Barletta  
Economist  
(Former President of Panama and Minister  
of Planning)

Héctor Castillo T.  
Associate  
Peat, Marwick, Mitchell & Co.

Ricardo Cazorla  
Vice President  
Chase Bank

Guillermo Chapman  
President  
INDESA

Fernando Barría  
Vice President  
Chase Bank

José Chong-Hon  
Associate Director  
Peat, Marwick, Mitchell & Co.

Alejandro Cordero  
President  
Association of Economists

René Díaz  
General Manager  
Banco International de Panamá

Marco A. Fernandez  
Instituto Centroamericano de  
Administración de Empresas

Victoria H. Figge  
President  
Asociación Panameña de Ejecutivos de  
Empresa (Panamanian Association of Business Executives)

José Galán  
INDESA

Rubén Lashman  
Director del Centro de  
Estudios Económicos

Eduardo Lee  
Associate  
Peat, Marwick, Mitchell & Co.

Antonio Niño  
Past President  
Asociación Panameña de Ejecutivos de  
Empresa (Panamanian Association of Business Executives)

Domingo de Obaldía G. de P.  
Executive Director  
Asociación Panameña de Ejecutivos de  
Empresa (Panamanian Association of Business Executives)

Ricardo E. Ortega C.  
Sr. Vice President  
Asociación Panameña de Ejecutivos de Empresa (Panamanian Association of Business Executives)

Juan Pascual  
Owner  
Pascual Candy Manufacturing Co.

Paul Smith  
General Director  
Banco Continental

Eduardo C. Urriola  
Vice President  
Citibank

Octavio A. Vallarino  
Owner, Empresas Vallerino

Ruben Lachman Varela  
Director, Center of Economic Studies  
Asociación Panameña de Ejecutivos de Empresa (Panamanian Association of Business Executives)

### **U.S.AID/Panama Officials**

John Clary  
Program Officer

Harry Dorcus  
Controller

Joslyn Fearon  
Economist

Felipe Frederick  
Economist

Kevin Kelly  
Panama Mission Director

Robert Mathia  
Project and Program Officer

Kermit Moh  
Private Sector Officer

Jose Sanchez  
Engineer

Nilka de Varela  
Economist

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